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SUBJECT: UK STILL IN RECESSION AND FACING SLOW, VOLATILE RECOVERY

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¶1. (SBU) Summary: The UK economy is still in recession and faces a slow, patchy recovery. According to official data released October 23, output in the third quarter was significantly weaker than expected. Economists at Oxford Economics and Morgan Stanley expect the UK to emerge from recession in the fourth quarter, in line with Chancellor Darling's forecast that growth will return by the end of the year, but have not ruled-out a "double-dip" recession. Weak sterling may improve the prospects of an export-driven recovery. Poor credit availability and mounting public debt pose significant risks to recovery. While the Bank of England's quantitative easing program could affect credit conditions, the Bank faces difficult decisions about when to start unwinding its position. Unemployment is set to stabilize next year, at a peak of approximately 9 percent. Inflation is likely to remain below the Bank of England's two percent target in the medium term. End summary.

UK Faces Bumpy Recovery

¶2. (SBU) The UK economy is still in recession, with a 0.4 percent contraction of GDP in the third quarter, according to data released by the Office for National Statistics on October 23. Output was significantly weaker than expected, with many analysts previously forecasting mild growth (of approximately 0.2 percent) which would have kick-started the recovery. The UK has now had six consecutive quarters of contracting output, the longest period of contraction since quarterly records began in 1955. It has been one of the global economic stragglers, with an emergence from the recession only expected in the fourth quarter, according to Andrew Goodwin, a consultant for Oxford Economics, a forecasting firm. During a macroeconomic briefing, Goodwin said the UK remains a long way behind most G7 countries, only performing better than Canada in the second quarter. He blamed this on sluggish domestic demand as consumers and businesses deleverage. Andrea Boltho, an Oxford University professor, said "spring is in the air," but the UK will not see a return to business as usual for a long time. He said it would take approximately 12 quarters for UK GDP growth to return to peak levels.

¶3. (SBU) Oxford Economics expects growth in the fourth quarter of 0.5 percent, slightly more pessimistic than Morgan Stanley's forecast. Melanie Baker, Morgan Stanley's chief UK economist, told us she expects 0.8 percent growth in the final quarter of 2009. She forecasts strong end of year growth driven by money from HMG's car scrappage scheme and increased consumer spending resulting from the imminent reversal of the value-added tax (VAT) cut (in January 2010 VAT will return to 17.5 percent after a year at 15 percent). She believes, however, 2010 will be a subpar year. Household savings rates are likely to increase, with consumer spending slowing as consumers deleverage. Business investment, likely to be low because of spare capacity, will not be a driver of recovery.

¶4. (SBU) The exact shape of the recovery is unknown. Baker said there is great uncertainty around all forecasts because of continued uncertainty around the fiscal outlook. While most analysts expect significant fiscal tightening following the election, the speed of this tightening will depend largely on the governing political party. She said people will remain concerned about the potential for a "double-dip" or "W-shaped" recession through next year. Echoing concern about a W-shaped recession, Goodwin said that while growth could be boosted by inventory rebuilding through the remainder of 2009, final demand may remain weak as banks and households deleverage. This would result in sluggish growth through 2010 and 2011, despite an initial bounce-back in the second half of ¶2009.

Possible Export-Driven Recovery

¶5. (SBU) The UK's economic recovery is expected to be slow and patchy, largely because it is difficult to detect a sustainable driver of growth. Both Goodwin and Baker expect fiscal policy will be limited in its ability to support economic recovery. There is no money left, they say, for further fiscal stimulus, despite media speculation that Chancellor Darling could announce further stimulus in his pre-Budget report. Baker told us consumer spending also will remain subdued, domestic business investment will likely be weak in the near term, and the bulk of government spending has already played through. While loose monetary policy may drive growth in the near term, she said it is not a viable foundation for sustained economic recovery. One possible driver, however, is exports. Baker said exports are likely to be buoyed by sterling's weakness. The weak pound will place the UK in good stead to benefit from eventual growth in the eurozone. Her comments were echoed by Andy Scott, Director of International and UK Operations for the Confederation of British Industry (CBI). During an evidence session with the House

of Commons Business, Innovation and Skills Committee, Scott said the UK recovery will be supported by a strong export market. As the UK's domestic market "evaporates," companies are increasingly looking at overseas opportunities. Sterling's weakness, he said, will improve their competitiveness.

¶6. (SBU) However, there is reason to remain skeptical about the possibility of an export-driven recovery. Adam Marshall, Director of Policy at the British Chambers of Commerce, told the Committee that many companies have been driven to export markets looking for a quick fix. He said that while established companies will benefit from a weak sterling, companies new to exporting will find it more difficult. Costs of establishing in a foreign market, particularly the cost of foreign trade shows, will be heightened by the weak sterling. Oxford University's Boltho was also skeptical about relying on exports for recovery. He said Ireland, the UK's fourth largest export market, is still suffering from problems in its housing market, and is unlikely to be a large importer of UK goods and services.

Credit Conditions Pose Risk to Recovery

¶7. (SBU) A lack of bank lending poses a serious risk to recovery, according to Boltho. Prior to the crisis, he said, "banks would lend any amount to anyone, now they won't lend anything to anyone - regardless of how meritorious the project." Goodwin agreed credit is still scarce for consumers and businesses. Lending hasn't returned following its "spectacular collapse" in the second half of 2008 and first half of 2009 and lending is becoming more expensive as banks increase their margins. Morgan Stanley's Baker disagreed with their analysis. She told us that banks are showing signs of willingness to increase credit availability and are improving credit terms. She said demand for credit has not returned, particularly in the large corporate sector, where companies have just started raising funds in the capital markets. She acknowledged, though, there is unmet demand for credit among small companies. She said this problem requires a government solution and cannot be solved through further loosening of monetary policy. (Note: HMG has put

significant pressure on British banks to lend. It set 2009 lending targets for two partly nationalized banks, the Royal Bank of Scotland (GBP 25 billion) and Lloyds Banking Group (GBP 14 billion) in return for their participation in the asset protection scheme. Chancellor Darling and Business Secretary Lord Mandelson have also made public comments that banks should increase lending or HMG will be forced to take further action.)

¶8. (SBU) All three analysts believed the Bank of England's quantitative easing (QE) program is beginning to work and could eventually improve credit conditions. Goodwin said interbank spreads are back to normal levels and gilt yields are low, despite spiraling government borrowing. Money growth (M4), which was negative from October 2008 to May 2009, moved out of negative territory in July, although it is too early to tell whether this growth is durable. Goodwin thought there was a 50 percent chance the Bank of England would extend its QE program in November, alongside the publication of its inflation report. If it does extend the program, however, Goodwin thinks it will only be by GBP 25 - GBP 50 billion.

¶9. (SBU) Unwinding the Bank's position will be difficult and timing will be crucial. Goodwin said the Bank, HM Treasury and the Debt Management Office (which auctions UK government bonds) must work together to maintain stability in the gilt market once the Bank begins to dispose of its assets. He warned that the Bank will start selling its gilts at the same time HM Treasury increases its gilt auctions to finance borrowing. Therefore, he argued, gilt yields are likely to rise in the next six to twelve months. He said the Bank needs to be careful about the timing of the gilt sales, particularly needing to avoid choking off recovery by tightening monetary policy too soon.

Public Finances: Debt to Reach Almost 100 Percent of GDP

¶10. (SBU) Alongside poor credit conditions, weak public finances are cited as a risk to UK economic recovery. Public debt rose to 59 percent of GDP in September, as HMG borrowed GBP 77.3 billion in the first half of the fiscal year - the highest borrowing level for the period since 1946. Goodwin expected UK debt to reach almost 100 percent of GDP by 2010. He said social security payments are rising while income tax revenue is falling, so the fiscal deficit will continue to climb, particularly in the next six to twelve months. He said the massive fiscal deficit needs to be addressed. He expected an extended period of austerity - with potentially ten years of tax increases. His comments reflect wider concern regarding the UK's public purse. In its 2009 Sustainability Report, the European Commission said the UK is at high risk of running an

unsustainable deficit. It said the UK will suffer a "sustainability gap" of 12.4 percent - meaning tax increases or spending cuts of approximately GBP 200 billion a year will be necessary. The National Institute for Economic and Social Research warned about the sustainability of UK debt, saying fiscal consolidation will be expensive, but the faster it happens, the lower the rise in debt.

Unemployment Up, Inflation Down

¶11. (SBU) Public finances will be significantly impacted by further rises in unemployment until next year. Baker told us unemployment will stabilize next year, with a peak of around 9 percent (from a current rate of 7.9 percent). It will then begin to decline, but it is unlikely that there will be any rapid improvement. Goodwin also expects unemployment to peak towards the end of 2010. Opinion is divided on what will happen to CPI inflation in the short term, but there is consensus that it will remain below the Bank of England's two percent target in the medium term. Goodwin expected a prolonged period of below target inflation through 2012. Baker thought inflation would bounce back at the beginning of next year, above target, and then fall below target in 2011. She expected domestic inflationary pressure to remain subdued.

¶12. (SBU) Comment: Despite encouraging signs the UK is emerging from recession, there are still questions about the strength and sustainability of any recovery. Mounting public debt will remain an enormous drag on the economy and could undermine any recovery in the fourth quarter. Both the Labour and Conservative Parties will need to form credible, comprehensive plans to address mounting public debt in the run up to the next general election (see reftels). However, these plans will be contingent on the UK emerging from the downturn and embarking on a path of steady, sustainable growth. Implementing any fiscal tightening before the recovery is assured could risk choking off growth and pushing the economy back into recession.

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